

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

JUN - 4 1996

In the Matter of

Implementation of Cable Act
Reform Provisions of the
Telecommunications Act of 1996

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CS Docket No. 96-85

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To: The Commission

**COMMENTS OF THE NATIONAL LEAGUE OF CITIES AND THE
NATIONAL ASSOCIATION OF TELECOMMUNICATIONS OFFICERS
AND ADVISORS**

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SUMMARY

Congress exempted OVS from many provisions of the Cable Act only because unlike a cable system, two-thirds of an OVS system is to be truly open for use by video programmers over which the operator has no control or influence. If an OVS operator could directly or indirectly control the OVS capacity used by ostensibly independent video programmers, the two-third set-aside would be meaningless and defeat the purpose of the statute. The Commission therefore must define "affiliate" broadly.

The Commission must define any relationship exceeding the carrier-user relationship as "affiliation" for OVS purposes, because any such relationship could give an OVS operator indirect control or influence over a video programmer's program selection, or an incentive to discriminate in rates, terms, or conditions. The "carrier-user" restriction recognizes the myriad of non-ownership mechanisms through which a carrier can exercise control over its customers. To the extent that the "affiliate" definition relies on ownership to show affiliation, the threshold should be one percent, as in the former telco-cable cross-ownership rules. Similarly, the Commission's rules must include both voting and non-voting ownership interests as cognizable ownership interests and must also include minority interests in closely-held entities with a single majority shareholder.

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To: The Commission

The National League of Cities and the National Association of Telecommunications Officers and Advisors, by their attorneys, hereby file the following comments in response to the Order and Notice of Proposed Rulemaking ("NPRM") in the above-captioned proceeding, released April 9, 1996. These comments specifically respond to ¶ 95 of the NPRM, requesting comments on the definition of "affiliate" in the context of Open Video Systems.¹

¹Related issues concerning open video systems are addressed in the Comments of the National League of Cities et al. (April 1, 1996) ("OVS Comments") and Reply Comments of the National League of Cities et al. (April 11, 1996) ("OVS Reply Comments") filed in CS Docket No. 96-46, which comments are hereby incorporated by reference into CS Docket No. 96-85.

I. A STRONG DEFINITION OF "AFFILIATE" IS CRITICAL TO OPEN VIDEO SYSTEMS.

A. An Open Video System Is Defined By Its Availability To Unaffiliated Video Programming Providers.

Under the Telecommunications Act of 1996 ("1996 Act" or "Act"), a local exchange carrier ("LEC") can provide video programming to subscribers in four ways: (1) using radio transmission under Title III of the Communications Act of 1934 ("Communications Act"); (2) on a common carrier basis under Title II; (3) as a cable operator under Title VI; or (4) through an "open video system" ("OVS") under new § 653.² The key distinguishing factor between an OVS and a cable system is that unlike a cable system, an OVS is supposed to be "open," up to two-thirds of its capacity must be available to independent programmers not of the OVS operator's choosing to obtain carriage on rates, terms, and conditions that are just and reasonable and are not unjustly or unreasonably discriminatory.³ In other words, an OVS should serve as an outlet for new competition both to the OVS operator and the incumbent cable operator.

To ensure that an OVS will be truly open — and distinct from the closed, proprietary network of a cable system — Congress required the Commission to promulgate regulations prohibiting "an operator of an open video system and its affiliates from selecting the video programming services for carriage on more

²See 1996 Act, section 302(a) (adding new § 651(a)).

³See OVS Comments at 4-8; OVS Reply Comments at 3.

than one-third of the activated channel capacity" when demand exceeds that capacity.⁴ If an OVS operator could directly or indirectly control additional channels through affiliates, it could evade the one-third limitation and defeat the purpose of the statute. Thus, the term "affiliate" is the linchpin of the statutory OVS carriage requirements. Without an effective definition of "affiliate," as well as other necessary conditions, an OVS would simply be a closed cable system masquerading under another name.

The intent of Congress — to make OVS an option distinctively different from cable — must guide the Commission's interpretation of the term "affiliate" as used in the OVS rules. To the extent an OVS operator is able to exercise indirect control of any kind over the selection of programming on a channel, that channel must be counted as one occupied by an affiliate of the OVS operator. The Commission thus should define "affiliate" broadly in a way that encompasses the variety of equity and non-equity relationships through which an OVS operator might seek effectively to control program selection.

B. In the OVS Proceeding, LECs Admit That They Will Seek To Control All Channel Capacity.

The LECs' opening comments in the OVS proceeding leave no doubt of their desire to control effectively all OVS channel capacity if the Commission lets them. This is clear from the

⁴1996 Act, section 302(a) (adding new § 653(b)(1)(B)) (emphasis added).

repeated assertions that the LECs prefer the cable model, where they control all the programming, to open access, unless the Commission effectively waters down any truly open access requirements. Thus, Bell Atlantic et al. stated:

The market and the available technology are better suited to cable systems, over which operators exercise substantially greater editorial control than open video system operators will be permitted.⁵

USTA, speaking for the telephone industry as a whole, agreed:

This ability to select all of the programming on the system under the cable option is preferable to the open video system alternative, in which the total number of channels that the operator may program are limited.⁶

In expressing this clear preference for the ability to exercise editorial control of all channels, the LECs acknowledged that they have every incentive to control the use of all OVS capacity, directly or indirectly, if they can. Thus, unless the Commission defines "affiliate" relationships in a way that clearly and unmistakably prevents such influence, the LECs will construct OVS arrangements designed to favor some video programming providers over others.⁷

⁵Comments of Bell Atlantic et al., Implementation of Section 302 of the Telecommunications Act of 1996, CS Docket No. 96-46 at 3 (filed April 1, 1996); See OVS Reply Comments at 6-10.

⁶USTA Comments on Open Video Systems at 10 (April 1, 1996) ("USTA Comments"). Cf. U S West, Inc. Comments on Open Video Systems at 14 (April 1, 1996) (few if any LECs would be willing to construct a system on which they do not control all capacity).

⁷The LECs' declared preference for complete programming control is supported by the actual history of video dialtone. See, e.g., Joint Comments of Cablevision Systems Corporation and the California Cable Television Association at 6-8, 13 (April 1, 1996); Comments of Tele-Communications, Inc., at 8-9 & n.26 (April 1, 1996).

Congress recognized that a LEC would wish to gain both the advantages of OVS (reduced regulation) and the advantages of cable (complete control of capacity). If Congress had wished to allow that result, it could simply have repealed the Cable Act and replaced cable with OVS. But Congress did not do so. Rather, it created a conscious trade-off between cable and OVS: in return for federal regulatory benefits, an OVS operator is required to give up sole control over its channel capacity, two-thirds of which must be subject to non-discriminatory use by independent video programming providers at reasonable rates and terms.

Congress, however, relied on the Commission to take the specific steps necessary to prevent LECs from circumventing the two-thirds rule. The Commission therefore has an obligation to promulgate regulations strictly applying the two-thirds open programming requirement. Such regulations must include a broad

(April 1, 1996).

The LECs' willingness to discriminate extensively among video programming providers may also be seen in the wide range of factors they view as "reasonable" discrimination among such providers, including program content and market value; the type of programming offered (premium or pay-per-view); full-time versus part-time carriage; volume discounts; discounts for long-term commitments; financial requirements; indemnification requirements; assurances regarding rights to programming; interconnection and technical standards; an undefined "need to compete with incumbent cable operators"; customary industry practices (when none exist other than those of cable operators); customers' expectations; demand; and technical limitations. See, e.g., Bell Atlantic Comments at 9; NYNEX Comments at 10 (April 1, 1996). The need to address such discriminatory tactics in the definition of "affiliate" is particularly pressing because the Commission's initial OVS rules do not make it sufficiently clear that such tactics are forbidden. See 47 C.F.R. § 76.1503(a) (stating general nondiscrimination principle without more).

"affiliate" definition, recognizing that there are a variety of means through which an OVS operator can influence video programmers outside the context of equity ownership.

C. Because OVS Operators Receive Significant Regulatory Benefits Based On Their Limited Programming Control, the One-Third Programming Limitation Must Be Strictly Enforced.

According to the Commission's recent OVS order, OVS operators are supposed to obtain the advantage of reduced federal regulation in exchange for yielding control of two-thirds of system capacity to independent video programming providers.⁸ In other words, Congress exempted OVS from many provisions of the Cable Act⁹ only because two-thirds of the system is unavailable for use by the operator. The LECs, therefore, cannot reasonably ask the Commission also to turn a blind eye to the LECs' potential use of various mechanisms — both equity and non-equity — to dominate OVS channel capacity. Such a policy would grant

⁸Implementation of Section 302 of the Telecommunications Act of 1996, CS Docket No. 96-46, Second Report and Order at ¶ 2 (released June 3, 1996).

⁹According to the Second Report and Order, the Commission believes that Congress also intended to subsidize OVS by exempting OVS operators from local franchising requirements under state law. Id. at ¶¶ 207-222. As we explained in our OVS comments (see note 1 supra), that interpretation is mistaken. To the extent the Commission nevertheless seeks to subsidize OVS through benefits still greater than those intended by Congress, however, those extra benefits make it all the more imperative that the Commission prevent OVS operators from obliterating the sole difference between OVS and cable by indirectly controlling channel capacity beyond their statutory limits.

LECs valuable regulatory favors without requiring a fair return in the form of truly open access.¹⁰

II. THE COMMISSION MUST DEFINE ANY RELATIONSHIP EXCEEDING THE CARRIER-USER RELATIONSHIP AS "AFFILIATION" FOR OPEN VIDEO SYSTEM PURPOSES.

A. OVS Operators, If Not Prevented By the Commission, Will Be Able To Influence Program Selection Through Indirect, Non-Equity Relationships.

If OVS is to be a truly open system, the Commission's rules must be clear and precise enough to prevent manipulation of the capacity limits through behind-the-scenes relationships between the OVS operator and favored programmers. Any relationship that gives an OVS operator any indirect control or influence over a video programmer's program selection (much less an incentive to discriminate in rates, terms, or conditions) should make that programmer an affiliate of the OVS operator.

¹⁰It appears, on initial review, that the Commission's standard for review of OVS carriage rates would actually require independent video programming providers to compensate the OVS operator for "the loss of subscribers to the open video system operator's programming package resulting from carrying competing programming" — in other words, to ensure that the OVS operator captures exactly the same revenues it would receive if it were a cable operator programming the entire system! See 47 C.F.R. § 76.1504(e) ("The imputed rate also seeks to recognize the loss of subscribers to the open video system operator's programming package resulting from carrying competing programming"). If the Commission genuinely intends this nonsensical result, it follows that the OVS operator loses nothing by electing OVS over cable: it incurs no financial disadvantage in return for gaining the federal regulatory benefits of OVS. In such a context, a strong open access requirement — OVS's sole reason for being — would be the only conceivable rational basis for OVS's regulatory advantages. A strong definition of "affiliate" is essential for an effective open access requirement.

The Cable Act's current definition of "affiliate" certainly includes relationships that provide an OVS operator with such influence over programming. In this sense, "affiliate" includes "another person who owns or controls, or is owned or controlled by, or is under common ownership or control with, such person."¹¹ Under this definition, either ownership or control, without more, constitutes affiliation. Thus, to start with, a strong definition of "affiliate" for OVS purposes must include not only ownership or equity relations, but also non-ownership or non-equity relations that afford an OVS operator control over another entity.

"Control," however, can be exercised over a business in a variety of ways even where the business is not an affiliate in the usual corporate sense. Indeed, an OVS operator can exercise influence over a video programmer's programming in many indirect and hard-to-detect ways. For example, an OVS operator may provide attractive financing, marketing or staff support, promotion or cooperative marketing arrangements only to one favored programmer. Similarly, two ostensibly unaffiliated entities A and B could enter into a reciprocal relationship through which A serves as the "unaffiliated" programmer on B's systems while B plays the role of "unaffiliated" programmer on A's.¹²

¹¹Section 602(2) (emphasis added).

¹²See OVS Comments at 22; OVS Reply Comments at 24.

The Commission is, of course, aware that some LECs did employ such artifices in their efforts to evade the former cable-telco cross-ownership rules. For example, in Northwestern Indiana Telephone, the president of the telephone company provided loan and indemnity guarantees to the cable operator, and leased to the cable operator office space and property on which to place its headend facilities.¹³ Thus, the danger that LECs will use back-door relationships to evade the OVS capacity set-aside requirements is not merely hypothetical, but is demonstrated by experience and by the LECs' own comments in the OVS proceeding. Such relationships could enable an OVS operator to exercise significant influence over program selection, even if no equity ownership or ostensible corporate control were involved. Thus, an adequate definition of "affiliate" for OVS purposes must cover these indirect relationships.

B. Indirect Relationships Provide an OVS Operator With An Incentive To Discriminate.

For similar reasons, a lax affiliation standard would risk permitting OVS operators to discriminate against independent video programming providers, contravening the nondiscrimination provisions of the Act and allowing the OVS operator to evade the two-thirds set-aside requirement by filling up that capacity with ostensibly "unaffiliated," but nonetheless favored, video

¹³See, e.g., Northwestern Indiana Tel. Co., Inc. v. FCC, 872 F.2d 465, 467 (D.C. Cir. 1989), cert. denied, 493 U.S. 1035 (1990).

programmers. The OVS provision of the Act requires the Commission to promulgate regulations that:

prohibit an operator of an open video system from discriminating among video programming providers with regard to carriage on its open video system, and ensure that the rates, terms, and conditions for such carriage are just and reasonable, and are not unjustly or unreasonably discriminatory.¹⁴

As noted above, the LECs have admitted their incentive to exercise control over all programming on an OVS, rendering it an empty sham. One way for an OVS operator to do so is to discourage or prevent disfavored video programmers through discriminatory terms compared to those of favored programmers. Thus, the Commission's rules must ensure that the "affiliate" definition includes not only ownership or management-based affiliations, but also affiliations based on other types of relationship that can nevertheless give the operator effective control over a video programmer.

C. The Only Practical Way To Prevent Such Indirect Modes of Control Is To Limit Parties To A Carrier-User Relationship.

The Commission has previously been faced with the question of how to prevent indirect, non-equity artifices that undermine the purpose of its rules. To address this problem in the past in the analogous context of the former telco-cable cross-ownership prohibition, the Commission employed the "carrier-user" restriction. Pursuant to the "carrier-user" restriction:

¹⁴1996 Act, section 302(a) (adding new § 653(b)(1)(A)).

the term 'unrelated and unaffiliated' bars any financial or business relationship whatsoever by contract or otherwise, directly or indirectly, between the carrier and the customer, except only the carrier-user relationship.¹⁵

As stated above, the Cable Act definition of "affiliate" recognizes two ways in which an OVS operator may be involved indirectly in program selection: through ownership or through non-ownership control of the ostensible programmer. The "carrier-user" restriction recognizes the myriad of non-ownership mechanisms through which a carrier can exercise control:

Examples of situations in which a carrier and its customer will be deemed to be related or affiliated include the following among others: where one is the debtor or creditor of the other (except with respect to charges for communication service); where they have a common officer, director, or other employees at the management level; where there is any element of ownership or other financial interest by one in the other; and where any party has a financial interest in both.¹⁶

This distinction, developed in the Commission's former telco-cable cross-ownership rules, was designed to deal with many of the same concerns as in OVS. The Commission concluded that a broad affiliation standard was required to prevent the wide variety of possible non-equity arrangements and relationships

¹⁵See former 47 C.F.R. § 63.54, Note 1(a) (emphasis added).

¹⁶Former 47 C.F.R. § 63.54, Note 1(b). Under the telco-cable cross-ownership rules, the Commission allowed a limited exception for stockholders of a corporation having more than 50 stockholders. With respect to those stockholders, the Commission deemed relationships other than those based on ownership or managerial control to be non-cognizable for purposes of determining affiliations. Only stockholders that were officers or directors, or who directly or indirectly owned one percent or more of the outstanding voting stock, were deemed to be related or affiliated with them. See former 47 C.F.R. § 63.54, Note 2.

through which carriers could exercise influences over their customers, since the Commission could not possibly anticipate all of the possible arrangements by which a LEC might exert indirect influence or control.¹⁷

Similarly, in the OVS context, any relationship between an OVS operator and an ostensibly non-equity related programmer other than that of carrier and user inherently poses a substantial risk that the OVS operator will exercise control over programming, or will have an incentive for discrimination in rates, terms, or conditions. Thus, all relationships between the OVS operator and a video programmer that exceed a carrier-user relationship must be considered to involve "control" and be counted as "affiliation" for purposes of the OVS capacity limitations.¹⁸

¹⁷Final Report and Order In the Matter of Applications of Telephone Companies for Section 214 Certificate for Channel Facilities Furnished to Affiliated Community Antenna Television Stations, Docket No. 18509, 21 F.C.C.2d 307, 326 (1970).

¹⁸Billing and collection services performed by the OVS operator for all video programming providers on a non-discriminatory basis should be considered part of the carrier-user relationship, given the close relationship of these services to carriage and the practical difficulties of billing a subscriber separately for multiple programming services.

D. The Commission's Adjustment of the Affiliation Standard With Regard To Video Dialtone Is Not Applicable for OVS.

In 1992, the Commission revised its affiliation standard with respect to video dialtone systems.¹⁹ In the VDT Order, the Commission adopted "affiliation standards for telephone/cable cross-ownership similar to those that apply for cable/broadcast cross-ownership."²⁰ In that case, the Commission decided to ignore ownership interests less than five percent, both for closely-held and for widely-held entities.

The reasons given by the Commission for this change in the VDT Order, however, do not apply to OVS. In the VDT Order, the Commission concluded that it had to allow larger ownership interests to encourage LEC participation in video delivery, because the telco-cable cross-ownership ban was still in effect.²¹

¹⁹Second Report and Order, Recommendation to Congress, and Second Further Notice of Proposed Rulemaking, In the Matter of Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58 (1992) ("VDT Order").

²⁰VDT Order at ¶ 32.

²¹For example, the Commission stated that this "modest increase in our ownership affiliation standards would facilitate the telephone company participation in the video market" VDT Order at ¶ 35.

The Commission also stated in the VDT Order that this "modest increase in the permitted level of ownership would eliminate requests for waivers of the cross-ownership rules involving only slight increases in ownership," thus reducing burdens on the Commission and the industry. Id. Assuming that such a rationale could justify lenient affiliation rules, however, no such waivers are required under the 1996 Act. Thus, the Commission's reasons for relaxing the standard in the VDT Order no longer apply.

The 1996 Act, however, repealed that ban. LECs may now enter the video distribution market as cable operators, as well as through OVS and other methods, as indicated above. Thus, it is no longer necessary to relax the ownership standard for affiliation in order to permit LEC participation in the video marketplace, because the new Act already allows a LEC to participate in that market as a cable operator, through control of one-third of OVS system capacity or through wireless or true common carrier means. The issue facing the Commission here is unlike that in VDT: if OVS is to be something different from cable, as Congress intended, the Commission must apply a strong affiliation standard, as shown above.

III. THE OWNERSHIP CRITERION OF THE AFFILIATION STANDARD SHOULD ALLOW NO MORE THAN A ONE PERCENT INTEREST IN AN "UNAFFILIATED" PROGRAMMER.

For the reasons outlined above, the "affiliate" definition, to the extent that it relies on ownership to show affiliation, requires a low ownership threshold. To limit truly "unaffiliated" programmers to a carrier-user relationship, this ownership limit should be one percent, as in the former telco-cable cross-ownership rules.²²

²²Similarly, if the Commission for some reason chose to ignore non-ownership relationships and adopted an affiliation standard based solely on ownership percentage and management control, it would certainly be necessary to recognize any ownership interest of one percent or more as "affiliation." As shown above, however, a standard based solely on ownership percentage or managerial control would ignore the other types of relationships that can give an OVS operator effective programming control.

It is true that when the Commission amended its affiliation criteria in the VDT Order, it moved to a five percent ownership standard for affiliations, including both voting and non-voting ownership interests.²³ The Commission also applied similar standards in its rules on competitive access to cable programming and cost-of-service rate determinations.²⁴ Certainly the Commission can adopt no more lenient standard than this five percent threshold for OVS affiliation, given the extreme importance of distinguishing truly independent program providers in making OVS what Congress intended it to be.

The crucial nature of the issue for OVS, however (and the apparent absence of any other licensing or oversight control by the Commission that would be likely to curb abuses), argues strongly for a more stringent standard in OVS. This is because the relevant considerations are different with respect to OVS. The whole purpose of OVS as an alternative to cable, and the reason for the federal regulatory benefits given to OVS operators, is to afford truly open access to independent video

²³VDT Order at ¶ 36. See also Memorandum Opinion and Order on Reconsideration in the same proceeding, FCC 94-269, at ¶ 69 (1992).

²⁴See Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition Act of 1992 - Development of Competition and Diversity in Video Programming Distribution and Carriage, Report and Order, FCC 93-178 at ¶ 31 (1993) ("Programming Order"); Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Rate Regulation, MM Docket 93-215, Report and Order and Further Notice of Proposed Rulemaking, 9 FCC Rcd 4527 at ¶¶ 261-270 (Mar. 30, 1994); Second Report and Order, First Order on Reconsideration, and Further Notice of Proposed Rulemaking, FCC 95-502 at ¶ 142 (Jan. 26, 1996).

programming providers. An OVS operator could use limited ownership interests, possibly in combination with other leverage, to discriminate among video programming providers as well as to influence those provider's programming selection. Because the OVS operator is already in a dominant position as the operator and manager of the distribution system, the need to ensure the independence of unaffiliated programmers is all the greater.

Similarly, the Commission's rules must include both voting and non-voting ownership interests as cognizable ownership interests and must also include minority interests in closely-held entities with a single majority shareholder. In its mass media rules, the Commission stated that it would not include non-voting ownership interests as cognizable in determining the ownership threshold for affiliations because non-voting shareholders by definition have no control.²⁵ But the Commission rejected that reasoning in the VDT Order and in the Programming Order.²⁶ Unlike the mass media ownership rules, both video dialtone and competitive access to programming are concerned not only with programming diversity, but also with preventing discrimination. While non-voting interests may not grant control, they do give a financial incentive to discriminate. For that reason, the Commission deemed them cognizable for purposes

²⁵Report and Order, Docket Nos. 20521, 20548, BC 78-239, MM 83-46, RM-3653, RM-3695 and RM-4045, 97 FCC 2d 997, 1020 (1984) ("Mass Media Order").

²⁶See VDT Order at ¶ 36; Memorandum Opinion and Order on Reconsideration at ¶ 69; Programming Order at ¶ 31.

of determining affiliations. The case for considering all ownership interests is still stronger in OVS, where the concern for open access is paramount.

The Commission reached the same conclusion with respect to minority ownership interests in closely-held entities with a single majority shareholder. In the mass media multiple ownership context, the Commission determined that such a minority shareholder could have no effective control over the entity because the single majority shareholder had total control.²⁷ In the VDT Order and in the Programming Order, however, the Commission again decided that because of the added discrimination factor, such minority interests would be cognizable.²⁸

OVS is concerned not only with programming diversity, but also, and primarily, with open access and preventing discrimination among video programming providers. For that reason, the Commission, consistent with the reasoning of the VDT Order and the Programming Order, should deem both voting and non-voting interests cognizable for purposes of determining ownership affiliation thresholds. The rules should also include all minority shareholder interests, even in entities with a single majority shareholder. In either case, the non-voting or the minority shareholder has an economic incentive to discriminate.

²⁷Mass Media Order at 1008-1009.

²⁸See Memorandum Opinion and Order on Reconsideration at ¶ 69; Programming Order at ¶ 31.


IV. CONCLUSION

The Commission's OVS rules should provide that, for an "unaffiliated" programmer to qualify toward an OVS operator's two-thirds set-aside obligation, the OVS operator's relationship with such an unaffiliated programmer must be restricted to a carrier-user relationship. In addition, all equity interests of one percent or more held by an OVS operator in a programmer should be considered attributable for affiliation purposes.

Respectfully submitted,

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